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SUBJECT: CONGRESS APPROVES MOST 2010 REVENUE LEGISLATION

REF: MEXICO 3110

¶1. Summary. Legislators watered down the original GOM revenue and tax proposals (see reftel), eliminating some key elements of the original package, but maintaining an increase in value added taxes (IVA) and income tax rates. Finance Secretary Carstens said the package will help revive the economy. While President Calderon welcomed approval of the legislation, he emphasized that that declining oil production left the country with no fiscal leeway, and called for all political actors to work together to boost growth and employment. It is unclear whether this bill will help the GOM avoid a significant increase in the medium-term fiscal deficit, or a public debt downgrade from the main ratings agencies. With the economy expected to contract by about 7% during 2009 (its worst performance since the early 1930s), momentum for a downgrade may be unstoppable End Summary.

¶2. While President Calderon, publicly welcomed the November 2 approval of most 2010 revenue legislation, he emphasized that plunging oil production left the country with no fiscal leeway, and made a vague call for all political actors to reach an accord on an economic strategy to boost growth and employment. In a separate speech, Secretary Carstens said tax increases approved this week by lawmakers will generate public revenue of more than 1% of GDP and help revive the economy. The tax legislation passed November 1 as part of the 2010 budget package will provide MX\$136 billion (US\$10.2 billion) in extra revenue. He added that the extra money will be used for public works projects, social programs and the fight against organized crime.

¶3. The most significant defeat for the GOM was its proposal for an additional 2% value-added tax (IVA) - called a "sales tax" in the legislation -- that would cover all goods and services with no exceptions. Goods and services assessed at the current 15% rate would have paid 17%. Foodstuffs, health and education services, which currently have a 0% VAT, would also been taxed at the new 2% rate, which the GOM pledged to use to expand anti-poverty programs. However, the attempt to expand this 2% generalized IVA was soundly defeated, as was the case in the 2002 and 2004 budgets. Contacts in the GOM said the idea behind the 2% no-exception tax was to gradually replace the IVA, which has many exceptions, thereby creating a broader tax base.

Electoral Fear

¶4. While the PRI formed an alliance with Calderon's Administration to approve revenue legislation, the IVA defeat clearly showed that the PRI remains unwilling to risk bold taxation action, fearful that

its chances of regaining the presidency in 2012 would be jeopardized. (Comment: The PRI still blames the increase in the VAT rate in 1995, from 10% to 15%, as a crucial factor in its defeat in both the 2000 election (after holding power uninterruptedly since 1929) and their 1997 (first-time) loss of majority in the Chamber of Deputies. Therefore, the possibility of radical fiscal reform before 2013 is extremely low. End Comment.)

15. The legislative approval process was also extremely contentious and heavily politicized. President Calderon's hand-picked PAN party president and former private secretary, Cesar Nava, hamfistedly blamed the PRI for the tax increases in Chamber of Deputies revenue proposals and for being responsible for a budget that is "insufficient" in addressing Mexico's economic woes. His statements came after it was widely known that a deal had been worked between the GOM's budget team and key opposition deputies. The PRI in the Senate took revenge, modifying several taxes -- notably cancelling a 3% duty on internet use. It also forced Secretary Carstens to accept before the Senate that the GOM took full responsibility for tax increases.

Tax Increases

16. Other than the IVA proposal, Congress approved the main tax increases that the GOM had sought:

-- The top rate of income tax was increased from 28% to 30%. The hike exempts those who earn 10,300 pesos (\$780) per month or less, who account for more than two-thirds of taxpayers.

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-- The general VAT rate was increased from 15% to 16% (and 10 to 11% at the border), the first rise since the 1995 crisis.

-- The tax on bank cash deposits of 15,000 pesos and above was increased from 2% to 3%. The bank-deposit tax is aimed at the large informal economy in Mexico, where transactions are largely carried out in cash. It applies to cash deposits of 15,000 pesos or more per month.

-- There will be a 3% tax on telecommunication services except internet (instead of the 4% the GOM sought).

-- Taxes also were increased for beer, alcohol and tobacco products.

-- Businesses will be required to pay deferred taxes within five years. Mexico's leading business consortium, the Consejo Coordinador Empresarial (CCE) said they will file injunctions against this measure and appeal to the Supreme Court. (See Reftel)

Fiscal Meddling

17. Congress also amended key macroeconomic assumptions, increasing elbowroom to boost fiscal revenues, at least on paper:

-- It increased the fiscal deficit target from 0.5% to 0.75% of GDP.

-- It raised substantially the expected average price for the Mexican barrel of oil, from US\$53.9 to US\$59.0.

17. The oil price boost may well be realistic, as Mexican crude on November 3 stood at US\$73.16 per barrel. If the price stays at similar levels throughout 2010, pressure on public finances would diminish significantly (during January-September, the Mexican oil price averaged US\$52.9 per barrel). However, even if international demand for oil increases in 2010, increased worldwide supply would be expected to meet it. Therefore, it may be irresponsible for the GOM to expect prices to maintain the trend observed in recent weeks. Moreover, even if oil prices remain relatively high and stable, production continues to decline. During January-September, crude

production averaged 2.6 billion barrels per day, a 6.6% fall from levels recorded during the whole of 2008, and 22.9% plunge from the production peak recorded in 2004.

¶8. There are no indications that the GOM would save any unexpected oil windfall (if it materializes) to build a fiscal cushion. On the contrary, there is strong pressure from state and municipal governments to share any extra revenues (as in recent years). Therefore, there is no sign of serious medium-term fiscal consolidation.

Downgrade Momentum?

¶9. It is unclear whether this budget will satisfy rating agencies, as revenue changes probably will not. Both Standard & Poor's and Fitch assign Mexico's external debt BBB+, the third-lowest investment grade rating, with a negative outlook. What Congress approved appears to signal GOM inability to adapt to a situation where oil production is falling rapidly, and the economy remains extremely reliant on a volatile oil price. The most recent GOM figures indicate that from January-September, income from oil represented approximately 30% of all GOM revenues.

¶10. With the economy expected to contract by about 7% during 2009 (its worst performance since the early 1930s), momentum for a downgrade may be unstoppable. Mexico's total public debt, according to its broadest definition, is equivalent to 38% of GDP, well below that of many developed countries recording significant fiscal deficits. (Note: By comparison the U.S. runs a gross debt ratio close to 100% and Japan almost double that, according to the OECD. End Note.) However, it is open to question whether Mexico could find the additional financing it will require in 2010 in international capital markets without paying a higher cost.

Carstens Move?

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¶11. Another element of uncertainty is the future of Carstens, who is tipped to become the next governor of the central bank (Banxico) for 2010-15. Guillermo Ortiz, central bank governor since 1998, is respected internationally. However, Calderon is unlikely to ratify him for another term, as the two clashed repeatedly when Calderon was a member of Congress in the late 1990s. Carstens also is well-respected in the private sector and in the Congress, and finding a replacement of similar stature to head the finance ministry would be difficult. The Inter-American Development Bank vice-president, Santiago Levy, is being mentioned as a potential replacement as well as current Energy Secretary Georgina Kessel. Calderon will probably announce his decision on Banxico (which needs to be ratified in the Senate) after the budget has been approved.

Comment:

¶12. The rejection of the 2% anti-poverty tax does represent a blow for the GOM. Although the fiscal gap for 2010 is covered by the weaker tax changes, the increase in the fiscal deficit to 0.75% of GDP and a higher oil benchmark price, stop short of providing a long-term solution to falling public revenue and generating alternative income sources to replace its dependence on oil. While showing that it is willing to work with the GOM, the PRI also has shown that it fears the electoral consequences of supporting more radical tax reform, which may have to wait until 2013. After fighting the 2% tax and the IVA increase, PRI Senator Manlio Fabio Beltrones and private sector groups are currently calling for broad tax reform that includes general, indirect taxes. However, PRI lawmaker Oscar Levin -- close to PRI President Beatriz Paredes -- publicly acknowledged that a comprehensive tax reform would be likely when the PRI recovers the presidency in 2012, not before. Nevertheless, a downgrading of government debt may indeed take place as Congress has clearly shown that it is unable to respond with tough choices and adapt to a situation where oil production is

falling rapidly.